Chapter 20

Deficit Finance

**Multiple Choice Questions**

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| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| 1. | When a model takes into account the fact that several different generations may coexist simultaneously, this is known as a(n)      |  |  | | --- | --- | | A. | neoclassical model. |  |  |  | | --- | --- | | B. | life-cycle model. |  |  |  | | --- | --- | | C. | overlapping generation model. |  |  |  | | --- | --- | | D. | crowding-out model. | |

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| 2. | By the end of 2011, the federal debt was about      |  |  | | --- | --- | | A. | $20 billion. |  |  |  | | --- | --- | | B. | $80.6 billion. |  |  |  | | --- | --- | | C. | $1 trillion. |  |  |  | | --- | --- | | D. | $10.1 trillion. | |

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| 3. | Because of the differing account conventions, there is a great deal of arbitrariness in a number that purports to be      |  |  | | --- | --- | | A. | the deficit. |  |  |  | | --- | --- | | B. | the surplus. |  |  |  | | --- | --- | | C. | the debt. |  |  |  | | --- | --- | | D. | all of these answer options are correct. | |

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| 4. | During the period from 1999 - 2008, federal budget deficits      |  |  | | --- | --- | | A. | were never calculated. |  |  |  | | --- | --- | | B. | fell dramatically. |  |  |  | | --- | --- | | C. | increased as a percentage of GDP. |  |  |  | | --- | --- | | D. | can be regarded as structural. | |

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| 5. | The purpose of functional finance is to      |  |  | | --- | --- | | A. | decrease deficits through monetary policy. |  |  |  | | --- | --- | | B. | use fiscal policy to keep aggregate demand at the desired level, regardless of the impact on deficits. |  |  |  | | --- | --- | | C. | tax corporate income first at the corporate level, and then again when it is distributed to shareholders. |  |  |  | | --- | --- | | D. | use monetary policy to keep deficits stable over time. | |

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| 6. | High real interest rates      |  |  | | --- | --- | | A. | increase the demand for the domestic currency by foreigners. |  |  |  | | --- | --- | | B. | cause decreased job opportunity. |  |  |  | | --- | --- | | C. | cause worker productivity to decrease. |  |  |  | | --- | --- | | D. | crowd out interest-sensitive expenditures. | |

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| 7. | When government borrowing decreases private investment by raising the market interest rate, this is known as      |  |  | | --- | --- | | A. | the Director's Law. |  |  |  | | --- | --- | | B. | crowding out. |  |  |  | | --- | --- | | C. | positive economics. |  |  |  | | --- | --- | | D. | the Ramsey Rule. | |

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| 8. | At a given point in time, if all past deficits and surpluses were added, we would get the      |  |  | | --- | --- | | A. | Ricardian model. |  |  |  | | --- | --- | | B. | debt. |  |  |  | | --- | --- | | C. | crowding-out model. |  |  |  | | --- | --- | | D. | total amount of excess burden. | |

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| 9. | When the government borrows in the market, it      |  |  | | --- | --- | | A. | does not have to pay interest. |  |  |  | | --- | --- | | B. | is not required to pay back the entire principle. |  |  |  | | --- | --- | | C. | can get indefinite extensions on the loan. |  |  |  | | --- | --- | | D. | all of these answer options are correct. |  |  |  | | --- | --- | | E. | none of these answer options are correct. | |

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| 10. | Inflation      |  |  | | --- | --- | | A. | increases the real value of the debt. |  |  |  | | --- | --- | | B. | has no impact on the debt. |  |  |  | | --- | --- | | C. | decreases the real value of the debt. |  |  |  | | --- | --- | | D. | is always factored into any calculations of deficits or surpluses. | |

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| 11. | The portion of a government's indebtedness owed to foreigners is      |  |  | | --- | --- | | A. | external debt. |  |  |  | | --- | --- | | B. | internal debt. |  |  |  | | --- | --- | | C. | not recoverable. |  |  |  | | --- | --- | | D. | net debt. | |

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| 12. | Which one of the following statements is true?      |  |  | | --- | --- | | A. | A budget surplus will reduce national saving. |  |  |  | | --- | --- | | B. | A budget deficit decreases national saving. |  |  |  | | --- | --- | | C. | A budget deficit will decrease interest rates. |  |  |  | | --- | --- | | D. | A budget deficit increases national savings. | |

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| 13. | According to a model of intergenerational equity, if future generations are expected to be better off than the current generation, transfers should      |  |  | | --- | --- | | A. | go from the richer generation to the poorer generation. |  |  |  | | --- | --- | | B. | not be done at all. |  |  |  | | --- | --- | | C. | go from the poorer generation to the richer generation. |  |  |  | | --- | --- | | D. | be weighted by increases in the inflation rate. | |

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| 14. | According to the Ricardian view of government deficits,      |  |  | | --- | --- | | A. | any future burden of tax financing should be ignored. |  |  |  | | --- | --- | | B. | government deficits reduce interest rates. |  |  |  | | --- | --- | | C. | taxpayers are less capable of saving when debt finance is used rather than tax finance. |  |  |  | | --- | --- | | D. | the private sector supply of loanable funds will increase in the face of government deficits. | |

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| 15. | The burden of the debt can be viewed as      |  |  | | --- | --- | | A. | a moral question. |  |  |  | | --- | --- | | B. | a political question. |  |  |  | | --- | --- | | C. | a financial question. |  |  |  | | --- | --- | | D. | all of these answer options are correct. | |

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| 16. | Lerner's view on debt financing is      |  |  | | --- | --- | | A. | Future generations bear a burden of external debt. |  |  |  | | --- | --- | | B. | Burden of debt can be transferred across generations. |  |  |  | | --- | --- | | C. | Internal debt creates no burden for the future generations. |  |  |  | | --- | --- | | D. | Government debt crowds-out the available funds for private sector. | |

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| 17. | The burden of the debt does not depend on whether debt finance crowds out private investment.      |  |  | | --- | --- | | A. | True |  |  |  | | --- | --- | | B. | False |  |  |  | | --- | --- | | C. | Uncertain | |

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| 18. | The level of economic activity in a given year will cause the budget deficit to vary.      |  |  | | --- | --- | | A. | True |  |  |  | | --- | --- | | B. | False |  |  |  | | --- | --- | | C. | Uncertain | |

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| 19. | The burden of debt is borne by future generations.      |  |  | | --- | --- | | A. | True |  |  |  | | --- | --- | | B. | False |  |  |  | | --- | --- | | C. | Uncertain | |

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| 20. | The United States has not had a surplus in the last 30 years.      |  |  | | --- | --- | | A. | True |  |  |  | | --- | --- | | B. | False |  |  |  | | --- | --- | | C. | Uncertain | |

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| 21. | High interest rates contribute to a lower federal budget deficit.      |  |  | | --- | --- | | A. | True |  |  |  | | --- | --- | | B. | False |  |  |  | | --- | --- | | C. | Uncertain | |

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| 22. | From an efficiency standpoint, one must compare the excess burdens of tax and debt finance.      |  |  | | --- | --- | | A. | True |  |  |  | | --- | --- | | B. | False |  |  |  | | --- | --- | | C. | Uncertain | |

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| 23. | Surpluses will help future generations more than deficits will hurt future generations due to inflation and taxes.      |  |  | | --- | --- | | A. | True |  |  |  | | --- | --- | | B. | False |  |  |  | | --- | --- | | C. | Uncertain | |

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| 24. | In the year 2008, nearly half of all privately held federal debt was held by foreign investors.      |  |  | | --- | --- | | A. | True |  |  |  | | --- | --- | | B. | False |  |  |  | | --- | --- | | C. | Uncertain | |

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| 25. | Total Government Debt is the sum of previous surplus and deficits.      |  |  | | --- | --- | | A. | True |  |  |  | | --- | --- | | B. | False |  |  |  | | --- | --- | | C. | Uncertain | |

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| 26. | Ricardian view on debt is that the form of government finance is irrelevant.      |  |  | | --- | --- | | A. | True |  |  |  | | --- | --- | | B. | False |  |  |  | | --- | --- | | C. | Uncertain | |

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| 27. | Most economists - both liberals and conservatives - believe a balanced budget amendment is an ill-conceived idea.      |  |  | | --- | --- | | A. | True |  |  |  | | --- | --- | | B. | False |  |  |  | | --- | --- | | C. | Uncertain | |

**Essay Questions**

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| 28. | Refer to Figure 20.3 below. Suppose the equation that equates excess burden to the tax rate can be written as EB = t2, where EB is excess burden and t is the tax rate.      (A) Suppose the tax rate t is initially 12 percent. How much excess burden is generated? (B) If the tax rate doubles to 24 percent, what happens to excess burden? |

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| 29. | Suppose, in 2008, the federal debt was $5 trillion. That year, the United States ran a deficit of $455 billion. During the course of the year, the inflation rate was 3.8%. How much is the "inflation tax"? |

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| 30. | You make a loan to the government of $100. The government promises to pay you back some sum of money in two years. The interest rate will be 4 percent over that period, but inflation will be 4 percent. How much will you require that the government pay you in two years in the absence of any inflation? With inflation? |

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| 31. | If raising taxes or borrowing are your only two choices of financing current expenditures, which would you choose, and why, if you were in charge of setting policy? |

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| 32. | We have learned from this chapter that the real value of the debt is eroded by inflation and may be overestimated because of it and other factors. Do you feel that the debt will be a major concern during your working lifetime and retirement? |

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| 33. | If we assume that government borrowing crowds out private investment, then future generations will have a smaller capital stock. Ricardo's view is that this will not be the case, because people are forward looking. Do you agree? |

Chapter 20 Deficit Finance Answer Key

**Multiple Choice Questions**

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| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| 1. | When a model takes into account the fact that several different generations may coexist simultaneously, this is known as a(n)      |  |  | | --- | --- | | A. | neoclassical model. |  |  |  | | --- | --- | | B. | life-cycle model. |  |  |  | | --- | --- | | **C.** | overlapping generation model. |  |  |  | | --- | --- | | D. | crowding-out model. | |

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| *AACSB: Reflective Thinking Accessibility: Keyboard Navigation Blooms: Remember Difficulty: 1 Easy Topic: The Burden of the Debt* |

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| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| 2. | By the end of 2011, the federal debt was about      |  |  | | --- | --- | | A. | $20 billion. |  |  |  | | --- | --- | | B. | $80.6 billion. |  |  |  | | --- | --- | | C. | $1 trillion. |  |  |  | | --- | --- | | **D.** | $10.1 trillion. | |

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| *AACSB: Reflective Thinking Accessibility: Keyboard Navigation Blooms: Remember Difficulty: 1 Easy Topic: How Big is the Debt?* |

|  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| 3. | Because of the differing account conventions, there is a great deal of arbitrariness in a number that purports to be      |  |  | | --- | --- | | A. | the deficit. |  |  |  | | --- | --- | | B. | the surplus. |  |  |  | | --- | --- | | C. | the debt. |  |  |  | | --- | --- | | **D.** | all of these answer options are correct. | |

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| *AACSB: Reflective Thinking Accessibility: Keyboard Navigation Blooms: Remember Difficulty: 1 Easy Topic: Overview* |

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| 4. | During the period from 1999 - 2008, federal budget deficits      |  |  | | --- | --- | | A. | were never calculated. |  |  |  | | --- | --- | | B. | fell dramatically. |  |  |  | | --- | --- | | **C.** | increased as a percentage of GDP. |  |  |  | | --- | --- | | D. | can be regarded as structural. | |

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| *AACSB: Reflective Thinking Accessibility: Keyboard Navigation Blooms: Remember Difficulty: 1 Easy Topic: How Big is the Debt?* |

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| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| 5. | The purpose of functional finance is to      |  |  | | --- | --- | | A. | decrease deficits through monetary policy. |  |  |  | | --- | --- | | **B.** | use fiscal policy to keep aggregate demand at the desired level, regardless of the impact on deficits. |  |  |  | | --- | --- | | C. | tax corporate income first at the corporate level, and then again when it is distributed to shareholders. |  |  |  | | --- | --- | | D. | use monetary policy to keep deficits stable over time. | |

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| *AACSB: Reflective Thinking Accessibility: Keyboard Navigation Blooms: Remember Difficulty: 1 Easy Topic: To Tax or to Borrow* |

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| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| 6. | High real interest rates      |  |  | | --- | --- | | **A.** | increase the demand for the domestic currency by foreigners. |  |  |  | | --- | --- | | B. | cause decreased job opportunity. |  |  |  | | --- | --- | | C. | cause worker productivity to decrease. |  |  |  | | --- | --- | | D. | crowd out interest-sensitive expenditures. | |

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| *AACSB: Reflective Thinking Accessibility: Keyboard Navigation Blooms: Remember Difficulty: 1 Easy Topic: The Burden of the Debt* |

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| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| 7. | When government borrowing decreases private investment by raising the market interest rate, this is known as      |  |  | | --- | --- | | A. | the Director's Law. |  |  |  | | --- | --- | | **B.** | crowding out. |  |  |  | | --- | --- | | C. | positive economics. |  |  |  | | --- | --- | | D. | the Ramsey Rule. | |

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| *AACSB: Reflective Thinking Accessibility: Keyboard Navigation Blooms: Remember Difficulty: 1 Easy Topic: The Burden of the Debt* |

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| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| 8. | At a given point in time, if all past deficits and surpluses were added, we would get the      |  |  | | --- | --- | | A. | Ricardian model. |  |  |  | | --- | --- | | **B.** | debt. |  |  |  | | --- | --- | | C. | crowding-out model. |  |  |  | | --- | --- | | D. | total amount of excess burden. | |

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| *AACSB: Reflective Thinking Accessibility: Keyboard Navigation Blooms: Remember Difficulty: 1 Easy Topic: How Big is the Debt?* |

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| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| 9. | When the government borrows in the market, it      |  |  | | --- | --- | | A. | does not have to pay interest. |  |  |  | | --- | --- | | B. | is not required to pay back the entire principle. |  |  |  | | --- | --- | | C. | can get indefinite extensions on the loan. |  |  |  | | --- | --- | | D. | all of these answer options are correct. |  |  |  | | --- | --- | | **E.** | none of these answer options are correct. | |

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| *AACSB: Reflective Thinking Accessibility: Keyboard Navigation Blooms: Remember Difficulty: 1 Easy Topic: The Burden of the Debt* |

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| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| 10. | Inflation      |  |  | | --- | --- | | A. | increases the real value of the debt. |  |  |  | | --- | --- | | B. | has no impact on the debt. |  |  |  | | --- | --- | | **C.** | decreases the real value of the debt. |  |  |  | | --- | --- | | D. | is always factored into any calculations of deficits or surpluses. | |

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| *AACSB: Reflective Thinking Accessibility: Keyboard Navigation Blooms: Remember Difficulty: 1 Easy Topic: How Big is the Debt?* |

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| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| 11. | The portion of a government's indebtedness owed to foreigners is      |  |  | | --- | --- | | **A.** | external debt. |  |  |  | | --- | --- | | B. | internal debt. |  |  |  | | --- | --- | | C. | not recoverable. |  |  |  | | --- | --- | | D. | net debt. | |

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| *AACSB: Reflective Thinking Accessibility: Keyboard Navigation Blooms: Remember Difficulty: 1 Easy Topic: The Burden of the Debt* |

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| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| 12. | Which one of the following statements is true?      |  |  | | --- | --- | | A. | A budget surplus will reduce national saving. |  |  |  | | --- | --- | | **B.** | A budget deficit decreases national saving. |  |  |  | | --- | --- | | C. | A budget deficit will decrease interest rates. |  |  |  | | --- | --- | | D. | A budget deficit increases national savings. | |

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| *AACSB: Reflective Thinking Accessibility: Keyboard Navigation Blooms: Understand Difficulty: 2 Medium Topic: The Burden of the Debt* |

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| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| 13. | According to a model of intergenerational equity, if future generations are expected to be better off than the current generation, transfers should      |  |  | | --- | --- | | **A.** | go from the richer generation to the poorer generation. |  |  |  | | --- | --- | | B. | not be done at all. |  |  |  | | --- | --- | | C. | go from the poorer generation to the richer generation. |  |  |  | | --- | --- | | D. | be weighted by increases in the inflation rate. | |

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| *AACSB: Reflective Thinking Accessibility: Keyboard Navigation Blooms: Understand Difficulty: 2 Medium Topic: To Tax or to Borrow* |

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| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| 14. | According to the Ricardian view of government deficits,      |  |  | | --- | --- | | A. | any future burden of tax financing should be ignored. |  |  |  | | --- | --- | | B. | government deficits reduce interest rates. |  |  |  | | --- | --- | | C. | taxpayers are less capable of saving when debt finance is used rather than tax finance. |  |  |  | | --- | --- | | **D.** | the private sector supply of loanable funds will increase in the face of government deficits. | |

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| *AACSB: Reflective Thinking Accessibility: Keyboard Navigation Blooms: Understand Difficulty: 2 Medium Topic: The Burden of the Debt* |

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| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| 15. | The burden of the debt can be viewed as      |  |  | | --- | --- | | A. | a moral question. |  |  |  | | --- | --- | | B. | a political question. |  |  |  | | --- | --- | | C. | a financial question. |  |  |  | | --- | --- | | **D.** | all of these answer options are correct. | |

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| *AACSB: Reflective Thinking Accessibility: Keyboard Navigation Blooms: Understand Difficulty: 2 Medium Topic: To Tax or to Borrow* |

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| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| 16. | Lerner's view on debt financing is      |  |  | | --- | --- | | A. | Future generations bear a burden of external debt. |  |  |  | | --- | --- | | B. | Burden of debt can be transferred across generations. |  |  |  | | --- | --- | | **C.** | Internal debt creates no burden for the future generations. |  |  |  | | --- | --- | | D. | Government debt crowds-out the available funds for private sector. | |

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| *AACSB: Reflective Thinking Accessibility: Keyboard Navigation Blooms: Remember Difficulty: 1 Easy Topic: The Burden of the Debt* |

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| --- | --- | --- | --- | --- | --- | --- | --- |
| 17. | The burden of the debt does not depend on whether debt finance crowds out private investment.      |  |  | | --- | --- | | A. | True |  |  |  | | --- | --- | | **B.** | False |  |  |  | | --- | --- | | C. | Uncertain | |

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| *AACSB: Reflective Thinking Accessibility: Keyboard Navigation Blooms: Understand Difficulty: 2 Medium Topic: The Burden of the Debt* |

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| --- | --- | --- | --- | --- | --- | --- | --- |
| 18. | The level of economic activity in a given year will cause the budget deficit to vary.      |  |  | | --- | --- | | **A.** | True |  |  |  | | --- | --- | | B. | False |  |  |  | | --- | --- | | C. | Uncertain | |

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| *AACSB: Reflective Thinking Accessibility: Keyboard Navigation Blooms: Remember Difficulty: 1 Easy Topic: The Burden of the Debt* |

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| 19. | The burden of debt is borne by future generations.      |  |  | | --- | --- | | A. | True |  |  |  | | --- | --- | | B. | False |  |  |  | | --- | --- | | **C.** | Uncertain | |

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| *AACSB: Reflective Thinking Accessibility: Keyboard Navigation Blooms: Remember Difficulty: 1 Easy Topic: The Burden of the Debt* |

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| 20. | The United States has not had a surplus in the last 30 years.      |  |  | | --- | --- | | A. | True |  |  |  | | --- | --- | | **B.** | False |  |  |  | | --- | --- | | C. | Uncertain | |

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| *AACSB: Reflective Thinking Accessibility: Keyboard Navigation Blooms: Remember Difficulty: 1 Easy Topic: How Big is the Debt?* |

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| 21. | High interest rates contribute to a lower federal budget deficit.      |  |  | | --- | --- | | A. | True |  |  |  | | --- | --- | | **B.** | False |  |  |  | | --- | --- | | C. | Uncertain | |

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| *AACSB: Reflective Thinking Accessibility: Keyboard Navigation Blooms: Understand Difficulty: 2 Medium Topic: The Burden of the Debt* |

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| 22. | From an efficiency standpoint, one must compare the excess burdens of tax and debt finance.      |  |  | | --- | --- | | **A.** | True |  |  |  | | --- | --- | | B. | False |  |  |  | | --- | --- | | C. | Uncertain | |

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| *AACSB: Reflective Thinking Accessibility: Keyboard Navigation Blooms: Remember Difficulty: 1 Easy Topic: To Tax or to Borrow* |

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| 23. | Surpluses will help future generations more than deficits will hurt future generations due to inflation and taxes.      |  |  | | --- | --- | | A. | True |  |  |  | | --- | --- | | B. | False |  |  |  | | --- | --- | | **C.** | Uncertain | |

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| *AACSB: Reflective Thinking Accessibility: Keyboard Navigation Blooms: Remember Difficulty: 1 Easy Topic: The Burden of the Debt* |

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| 24. | In the year 2008, nearly half of all privately held federal debt was held by foreign investors.      |  |  | | --- | --- | | A. | True |  |  |  | | --- | --- | | **B.** | False |  |  |  | | --- | --- | | C. | Uncertain | |

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| *AACSB: Reflective Thinking Accessibility: Keyboard Navigation Blooms: Remember Difficulty: 1 Easy Topic: The Burden of the Debt* |

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| 25. | Total Government Debt is the sum of previous surplus and deficits.      |  |  | | --- | --- | | **A.** | True |  |  |  | | --- | --- | | B. | False |  |  |  | | --- | --- | | C. | Uncertain | |

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| *AACSB: Reflective Thinking Accessibility: Keyboard Navigation Blooms: Remember Difficulty: 1 Easy Topic: How Big is the Debt?* |

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| 26. | Ricardian view on debt is that the form of government finance is irrelevant.      |  |  | | --- | --- | | **A.** | True |  |  |  | | --- | --- | | B. | False |  |  |  | | --- | --- | | C. | Uncertain | |

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| *AACSB: Reflective Thinking Accessibility: Keyboard Navigation Blooms: Remember Difficulty: 1 Easy Topic: The Burden of the Debt* |

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| 27. | Most economists - both liberals and conservatives - believe a balanced budget amendment is an ill-conceived idea.      |  |  | | --- | --- | | **A.** | True |  |  |  | | --- | --- | | B. | False |  |  |  | | --- | --- | | C. | Uncertain | |

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| *AACSB: Reflective Thinking Accessibility: Keyboard Navigation Blooms: Remember Difficulty: 1 Easy Topic: To Tax or to Borrow* |

**Essay Questions**

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| 28. | Refer to Figure 20.3 below. Suppose the equation that equates excess burden to the tax rate can be written as EB = t2, where EB is excess burden and t is the tax rate.      (A) Suppose the tax rate t is initially 12 percent. How much excess burden is generated? (B) If the tax rate doubles to 24 percent, what happens to excess burden?     (A) When the tax rate is 12 percent, EB is 0.122 = 0.0144. (B) When the tax rate doubles, EB is 0.242 = 0.0576, which is more than double. |

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| *AACSB: Analytic Blooms: Apply Difficulty: 3 Hard Topic: To Tax or to Borrow* |

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| 29. | Suppose, in 2008, the federal debt was $5 trillion. That year, the United States ran a deficit of $455 billion. During the course of the year, the inflation rate was 3.8%. How much is the "inflation tax"?     In order to calculate the "Inflation tax", multiply the federal debt by the inflation rate ($5 trillion × 0.038) = $190 billion = Inflation Tax. Effectively, the federal deficit is reduced to $455 billion - $190 billion = $365 billion. |

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| *AACSB: Analytic Blooms: Apply Difficulty: 3 Hard Topic: How Big is the Debt?* |

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| 30. | You make a loan to the government of $100. The government promises to pay you back some sum of money in two years. The interest rate will be 4 percent over that period, but inflation will be 4 percent. How much will you require that the government pay you in two years in the absence of any inflation? With inflation?     You could have saved the $100 dollars for two years, had X = 100(1.04)2 = $108.16, but the purchasing power of your money would have been decreased by inflation. So, to counter those effects, you would ask for X = 100(1.08)2 = $116.64. |

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| *AACSB: Analytic Blooms: Apply Difficulty: 3 Hard Topic: How Big is the Debt?* |

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| 31. | If raising taxes or borrowing are your only two choices of financing current expenditures, which would you choose, and why, if you were in charge of setting policy?     Both systems have drawbacks. Increasing taxes might limit economic growth by reducing consumer spending. Borrowing could cause crowding out by the private sector. The question can be answered by examining which system will create the most economic good, while causing the least amount of economic harm. A third alternative is to reduce current expenditures so that there is no need for deficit financing. This view is normally not very politically popular. |

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| *AACSB: Analytic Blooms: Evaluate Difficulty: 3 Hard Topic: To Tax or to Borrow* |

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| 32. | We have learned from this chapter that the real value of the debt is eroded by inflation and may be overestimated because of it and other factors. Do you feel that the debt will be a major concern during your working lifetime and retirement?     Although answers will vary, the debt will be an area for concern. The most troublesome portion will be the increasing share of debt held by foreign investors. Other obligations, such as Medicare and Social Security, will have a greater impact. |

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| *AACSB: Analytic Blooms: Evaluate Difficulty: 3 Hard Topic: How Big is the Debt?* |

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| 33. | If we assume that government borrowing crowds out private investment, then future generations will have a smaller capital stock. Ricardo's view is that this will not be the case, because people are forward looking. Do you agree?     There is evidence that says that this is partially true, by not totally proven. People that are able to do so will leave bequests to their children. The bigger question involves those who are not able to give. Who in the future will be responsible for them? |

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| *AACSB: Analytic Blooms: Evaluate Difficulty: 3 Hard Topic: The Burden of the Debt* |